

KNOWLEDGE SPILLOVER: THE IMPACT OF TYPES AND RECURRENCE OF NON- AUDIT SERVICES ON AUDIT FEES IN MALAYSIA

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DECLARATION

I hereby declare that the project is based on my original work except for quotations and citation which have been duly acknowledged. I also declare that it has not been previously or concurrently submitted for any other degree at USM or any other institutions.

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ABSTRAK

Isu kebebasan juruaudit telah menarik perhatian pihak kerajaan, badan perakaunan serta orang awam selepas tersebarnya skandal dan penyelewengan perakaunan di dalam dan di luar negara. Penawaran perkhidmatan bukan audit kepada klien oleh juruaudit telah lama dikhuatiri mengancam kebebasan juruaudit. Walau bagaimanapun, ada pendapat mengatakan bahawa penawaran perkhidmatan bukan audit bersama perkhidmatan audit menghasilkan limpahan pengetahuan (*knowledge spillover*) yang membantu meningkatkan kecekapan kerja audit. Maka tujuan kajian ini adalah untuk meninjau sama ada terdapat limpahan pengetahuan apabila perkhidmatan bukan audit ditawarkan dengan menganalisis hubungan di antara yuran perkhidmatan audit dengan yuran perkhidmatan bukan audit. Data diperolehi dari 696 laporan kewangan tahunan bagi syarikat senarai awam di Malaysia untuk tempoh 2007-2009. Hubungan di antara yuran perkhidmatan bukan audit dan yuran audit telah diuji secara umum dan terperinci berdasarkan pelbagai pembolehubah kawalan menggunakan teknik regresi.

Selaras dengan dapatan kajian lampau, dapatan menunjukkan bahawa perkhidmatan bukan audit secara umumnya mempunyai hubungan positif dengan yuran audit. Analisis dibuat mengikut tiga kategori perkhidmatan bukan audit iaitu berkaitan audit, percukaian dan perundingan, dan lain-lain perkhidmatan juga melaporkan hubungan positif untuk setiap kategori. Analisis hubungan juga dibuat untuk melihat hubungan perkhidmatan berulang bukan audit dengan yuran audit dan dapatan menunjukkan bahawa perkhidmatan berulang bukan audit tidak mempunyai hubungan yang signifikan dengan yuran audit. Walau bagaimanapun, analisis tambahan yang dibuat berdasarkan tiga kategori perkhidmatan berulang bukan audit melaporkan perkhidmatan berkaitan audit mempunyai hubungan yang negatif terhadap yuran audit. Ini menunjukkan bahawa terdapat limpahan pengetahuan apabila perkhidmatan berkaitan audit disediakan. Kajian lanjutan untuk menyiasat ancaman perkhidmatan bukan audit ke atas kebebasan juruaudit adalah disyorkan.

ABSTRACT

The issue of auditor independence has attracted the attention of the government, accounting bodies, and the general public especially after the unfolding of major international and local accounting scandals. The provision of non-audit services by auditors to their clients has been a matter of concern for many years as a threat to the auditor independence. However, the joint provision of non-audit services and audit services is also claimed to create knowledge spillovers that leads to a more efficient audit work. The purpose of this paper was to investigate knowledge spillovers by examining the association between audit fee and non-audit services. A sample of 696 firm-year observations from the financial reports of Malaysian public listed companies over the period 2007-2009 was obtained. The relationship between non-audit services and audit fee was tested by controlling other variables using regression analyses.

The findings showed that non-audit services reported a positive relationship with audit fee which was consistent with previous studies. The test was extended by segregating non-audit services into three categories, audit related, tax and consulting, and other services. The results showed that the relationship between the level of audit fees and non-audit services did not vary by category of non-audit services as these services had positive association with audit fee. The test was also extended to examine the relationship between recurring non-audit services and audit fee and no significant relationship was found. However, a further analysis by the three categories of recurring non-audit services showed that only recurring audit-related non-audit services had negative relationships with audit fee, indicated the existence of knowledge spillover through it. Further studies to investigate the threat of non-audit services towards auditor independence are recommended.

CHAPTER 1

INTRODUCTION

1.1 Introduction

This chapter introduces the outline of this study. Sections 1.2 and 1.3 highlight the background of the study and the problem statement respectively. Section 1.4 gives the research objectives and followed by Section 1.5 that presents the research questions. The definitions of key terms and major variables are included in Section 1.6 and the significance of the study is presented in Section 1.7. This chapter ends with Section 1.8 which gives a brief overview of the remaining chapters in the thesis.

1.2 Background of the study

In Malaysia, auditing firms range from large international companies to small partnerships that consist of only two or three partners. It is rare to see audit firms that operate as sole proprietorships. International companies are usually appointed to audit the country's large corporations while the smaller auditing firms attend to the small and medium enterprises (SMEs). The field of accounting has evolved in response to the social and economic needs of society. In its early days, accounting only dealt with the provision of the financial information which were required by a relatively few owners of business. As business and society became more complex over the years, the functions of accounting expanded in order to fulfill the needs of a variety of interested parties. The duties of the auditors also evolved as from providing only the audit services to the clients to the provision of non-audit services such as management advisory services (MAS) and tax services. In addition, from the nature of these non-

audit services, they can be divided into recurring and non-recurring non-audit services.

Regardless of the size of the firms and nature size of their clients, the auditing profession requires its practitioners to be highly ethical in delivering their services. The accounting profession has established categories of ethical standards under the AICPA Code of Professional Ethics by which the auditors must continue their independence. These categories include rules of conduct, their interpretations, as well as ethical rulings. Independence is an important ethics in the auditing profession because it is the foundation for the public's trust in the audit function. The situation is complicated as the primary focus of the auditors is to represent or act on the interest of the public or stakeholders of the companies but they are hired and being paid by the clients. When there are inconsistencies between duties of one group with the responsibilities to another, an ethical conflict will arise (Finn, 1988). This may lead to unethical conducts that will affect some of the parties involved.

The financial statement of every company in Malaysia has to be audited annually to comply with the rules and regulations under the licensing and tax requirements. Since the auditors must act in the interest of the public while getting paid by the client, independence, integrity and objectivity are the main issues in ethical conduct and judgment of the auditors. The key element of the integrity of audit process is auditor independence. The integrity of the independent audit function has to be maintained when any problem or issue arises about financial reporting. It is mandatory for auditors and required by the standards of the accounting profession. The collapse of WorldCom and Enron has negatively impacted the perception of the auditing and eroded public confidence towards auditor independence and the quality of audit services.

The independence of auditors has been an issue for decades. Auditor independence is the key element of the integrity of the audit process which will lead to the quality of the financial reporting. DeAngelo (1981) defined audit quality as the ability to detect and report any breach in the client's accounting system. Thus, auditors must be able to discover any misstatement or problem and are duty-bound report them to the public. The integrity of the independent audit function has to be rigorously maintained. Many studies have been conducted on the auditors' independence with most of them focus on the quality of the audit performed. These studies involved audit failures which have been linked to the closeness of auditor-client relationships. Since auditing must be done every year and can extend over decades as the client does not change the auditor every year, the tenure of the auditing firms with the audit clients has been shown to lead to close relationships between both parties. The close relationship is argued to affect the quality of audit performed which in turn leads to affect the auditor's independence in executing their responsibilities. As a result, audit partner rotation and the provision of non-audit services restrictions are among the principal provisions designed by Sarbanes-Oxley Act of 2002 to enhance auditor independence (Chen *et al.*, 2005).

In establishing and maintaining business and professional relationships the audit firms may offer services beyond objective auditing. The offering of non-audit services may be unavoidable and this in turn influences the auditor's independence. Concerns have been raised regarding non-audit services provided by the auditors. Auditors will have more understanding about the audit clients business operation and system by providing non-audit services, as well as, audit services which may be beneficial to the auditors in term of the efficiency of audit work. However, at the same time, it may also impair the auditors' independence.

In response to the outbreak of worldwide financial and the accounting fraud scandals involving public listed companies such as Transmile Group Berhad and Megan Media Holdings Berhad, the regulatory and legislative authorities in Malaysia have implemented a number of reforms to the audit functions. The accounting scandals have affected the trust of the stakeholders and eroded the integrity of the capital market, the regulators and the profession (Jaafar Sidek, 2008). One negative outcome is that the audit quality of financial statements is now viewed with suspicion.

1.3 Problem statement

The issues of audit quality or auditor independence have been discussed for years and became more serious after the outbreak of the major accounting scandals. The major concern is regarding non-audit services (NAS) provided by the auditor to its audit clients (auditee). The Metcalf Committee Staff Study (1976, as cited in Simunic, 1984) claims that the provision of audit services and non-audit services by the same auditors create a conflict of interest situation, that is, the auditors provide non-audit services and then audit their own work (self-review). Also, auditors may be reluctant to report any deficiencies or misstatements found while performing their consulting services. They would like to preserve their good reputation and not lose the lucrative revenues from the consulting services if they were dismissed as the auditors (Simunic, 1984). Gul *et al.* (2007) argued that the provision of non-audit services may impair auditors' independence, but Walker and Hay (2011) on the other hand, claimed that the joint provision of non-audit services and audit services increased audit work efficiency, calling it a knowledge spillover effect.

The relationship between non-audit services and audit services has been tested by examining the association of non-audit services with audit fee (Simunic, 1984;

Firth, 1997b, Ezzamel *et al.*, 2002; Che Ahmad *et al.*, 2006; Abdul Wahab *et al.*, 2010; Alexander and Hay, 2012) or restatements (Paterson and Valencia, 2011) or audit report lag (Walker and Hay, 2011). These non-audit services can be categorised based on their nature such as audit-related non-audit services, taxation services, and other services (Ezzamel *et al.*, 2002; Paterson and Valencia, 2011; Alexander and Hay, 2012). These tests also employed control variables such as client attributes, nature of the companies, and also political connections associated with them.

The provision of non-audit services is claimed to be a contributor to the impairment of auditor independence. On the other hand, the joint provision of non-audit services and audit services creates knowledge spillovers which will lead to audit efficiency as auditor have better understanding about the clients operations. Prior research about the relationship between non-audit services and auditor independence has been conducted widely in the United States, Australia and United Kingdom. However, the evidence on whether non-audit services actually impair independence is inconclusive.

Also, many studies have focused on audit quality and auditors' independence involving non-audit services but there is a limited amount of studies that focuses on audit quality and auditors' independence by the type of non-audit services offered by the auditors in Malaysia. Thus, this study investigated the relationship between non-audit services and audit services fee by types and recurrence of non-audit services.

1.4 Research objectives

The objectives of this study were thus to investigate the level of auditor independence by focusing on the various types of non-audit services. Specifically, they are:-

- (a) To investigate whether there is an existence of knowledge spillover due to provision of non-audit services;
- (b) To investigate whether the recurrence of non-audit services affects auditor independence by distinguishing between recurring and non-recurring non-audit services;
- (c) To test the heterogeneous nature of non-audit services on knowledge spillovers and auditor independence.

1.5 Research questions

To achieve the objectives, this study was conducted to answer the following research questions:-

- (a) Do knowledge spillovers occur when non-audit services are provided?
- (b) Do recurring and non-recurring non-audit services affect auditor independence?
- (c) Do the various types of non-audit services affect knowledge spillovers and auditor independence?

1.6 Definition of key terms

For better clarity of the concepts, the key terms used in this study are defined below:

1.6.1 Audit services

Audit services are part of statutory audit and are defined by the Malaysian Companies Act 1965 as comprising the preparation of financial statements that give true and fair view of the state of affairs of a company for a given financial year.

1.6.2 Audit services fee

Audit services fee consists of all fees necessary to perform the statutory audit works provided by the external auditors.

1.6.3 Non-audit services

Non-audit services, also known as non-statutory audit services, are services such as audit related, tax related, and other miscellaneous services provided either by the auditor and its affiliates or by third parties.

1.6.4 Non-audit services fees

Non-audit services fees are fees paid for the services other than statutory audit services. Bursa Malaysia (2012) defined non-audit fees as any fees paid for services rendered to the listed issuer or its subsidiaries other than for statutory auditing work.

1.6.5 Recurring non-audit services

Recurring non-audit services are complementary services such as tax services that are provided by the auditors and its affiliates on an ongoing or continuous basis.

1.6.6 Non-recurring non-audit services

Non-recurring non-audit services are complementary services that are offered once or intermittently. For example, if a service was offered in 2007, it would not be offered again in 2008. However, there is a possibility that it would be offered in 2009.

1.6.7 Auditor independence

Auditor independence is the objectivity and integrity of auditors in performing audit works and in giving their opinion. The Institute of Internal Auditor (2001) defined auditor independence as the ability to overcome pressures that would affect audit decisions.

1.6.8 Auditor's report

An audit opinion or an auditor's report is a report or statement of a client's financial position prepared by the independent or external auditor at the end of an audit investigation. The auditor reports on the nature of his or her work and on the degree of responsibility assumed. In the audit opinion, the auditor states that he or she has examined the client's financial statements for the year and indicates whether in his or her opinion the client's financial statements present fairly the financial position, results of operations, and changes in financial position for the year-ended in accordance with standard and regulations applied on a consistent basis. The four types of audit opinions are unqualified opinion, qualified opinion, adverse, and disclaimer.

1.6.9 Knowledge spillovers

Knowledge spillovers are exchanges of information or ideas between two or more parties which may have impact internally or externally to an organization. These spillovers facilitate the exchange of ideas, promoting creativity and innovation

(Carlino, 2001). In the auditing context, knowledge externalities or spillovers arise from interdependencies or interactions in the production of the two services, namely, audit and non-audit services (Simunic, 1984).

1.7 Significance of the study

The perceptions on auditor independence are more negative after the collapse of Enron when it was declared bankrupt in late 2001 and when accounting irregularities were found in government linked companies such as Transmile Group Berhad, Takaful Malaysia Berhad, Southern Bank Berhad, Megan Media Holdings Berhad and NasionCom Holdings Berhad. It has attracted significant attention by the public and the regulators regarding the importance of auditor independence. Therefore, this research investigated auditor independence with respect of the relationship between audit services fees and non-audit services fees by examining on the effect of recurring and non-recurring non-audit services. In addition, it also examine whether the provision of non-audit services create knowledge spillover.

The findings of this study will be useful for Malaysian Institute of Accountants (MIA), the government, and also audit firms in their efforts to improve on the ethicality of the auditors and thus to ensure sustainability of practice and guarantee public confidence towards the auditing profession. A negative relationship between audit fees and non-audit services fees is due to the occurrence of knowledge spillover which is an advantageous to the audit firm but on the other hand it also indicates the possibility of the existence of a threat to auditor independence. Hence, the auditors will be made aware of current situation and be guided to make better decisions to either to provide or not to provide non-audit services that may impair

their ethical judgment and objectivity. Thus, the findings of this study can improve the ethicality of the auditors.

Furthermore, this study may reduce the gap in literature as there is currently no research focusing on knowledge spillovers in Malaysia by examining the impact of types and recurrence non-audit services on audit fees. Research about the relationship between non-audit services and auditor independence has been widely conducted in the United States, Australia, and the United Kingdom. Also, many studies have focused on audit quality and auditors' independence involving non-audit services but there is a limited amount of studies that focuses the type of non-audit services offered by the auditors in Malaysia.

1.8 Organisation of the remaining chapters

This chapter provides an overview of this study. The next chapter discusses the institutional background in audit market in Malaysia. Chapter 3 reviews past research on auditor independence and knowledge spillovers including audit services fee, non-audit services fee and types of non-audit services. Chapter 4 meanwhile underlines the hypothesis developed and theoretical framework and Chapter 5 highlights the methodologies, the variables and the data. Chapter 6 discusses the results of the finding. The final chapter concludes this study and presents the summary of the findings, limitation of this study as well as suggestions for future research.

CHAPTER 2

INSTITUTIONAL BACKGROUND

2.1 Introduction

This chapter presents an overview of the audit market in Malaysia. Section 2.2 begins with the background of accounting and auditing profession in Malaysia and followed by Section 2.3 and Section 2.4 which discuss the audit services and fees charged to companies as well as the non-audit services respectively. Finally, Section 2.5 concludes this chapter.

2.2 Accounting and auditing profession in Malaysia

The regulation of company affairs in Malaysia is derived from the British system, especially with respect to the financial information provision. All firms registered including private and public companies in Malaysia are required by law to have their annual reports to be audited and submitted to the Securities Commission (SC) of Malaysia every year. In addition, public listed companies are required to publish their audited annual reports for presentation to the public.

Accountants and auditors in Malaysia are regulated under the Malaysian Institute of Accountants (MIA). MIA is a statutory body established under the Accountants Act 1967, to develop the accountancy profession. Its responsibilities include ensuring that the credibility of the profession is maintained through education, quality assurance and enforcement so that public interest is continuously upheld. MIA sets the By-Laws (On Professional Conduct & Ethics) as the standards of conducts for its members and other standards and guidelines, which are in line with the standards issued by the International Federation of Accountants (IFAC) and the International Auditing and Assurance Standards Board (IAASB).

The accounting profession has been growing steadily since 1983. As of 30 June 2011, the total membership stands at 27,156. It comprises 27,000 Chartered Accountants, 8 Licensed Accountants and 148 Associate Members. Accountants who have been admitted as members of MIA increased by 22.3% compared to the previous financial year. As of 30 June 2011, there were 2,043 member firms registered with MIA. It comprises 1,353 audit firms and 690 non-audit firms. In 2011, 82 firms were registered with the MIA consisting of 32 audit and 50 non-audit firms.

It is not surprising that the Big International audit firms control more than 50 percent of the audit market in Malaysia. The Big Eight includes Arthur & Young, Coopers & Lybrand, PriceWaterhouse, Arthur Andersen, Ernst & Whinney, Deloitte Haskins & Sells, Deloitte Touche Ross and KPMG. Following the mergers of Arthur & Young with Ernst & Whinney and Deloitte Haskin & Sells with Deloitte Touche Ross in 1989, the Big Eight auditing firms became the Big Six. An additional merger, this time between PriceWaterhouse and Cooper Lybrand in 1998, reduced the group to five firms. Then, finally, the corporate collapse of Arthur Andersen in 2002 brought together only four global auditing firms Ernst & Young, KPMG, Deloitte and PriceWaterhouseCoopers.

Thus, two categories of firms describe the public accounting firms in Malaysia, namely, the Big Four international firms which comprise KPMG, Deloitte, Ernst & Young and PriceWaterhouseCoopers and non-Big Four. The non-Big Four audit firms are the other public accounting firms such as Hanafiah Raslan & Mohamad, JB Lau & Associates and UHY Diong which are registered under the MIA and are not affiliated with the Big Four firms.

2.3 Audit services

An audit is a process of independent examination of records and accounts of business entities including limited companies, charities and professional firms to enable the auditors to form or express an opinion on the financial statements. It is known as statutory audit as the Malaysian Companies Act 1965 requires the auditors to satisfy themselves that the financial statements give true and fair view of the state of affairs of the company at the financial year ended. The scope of the audit should be accordance with:

- (a) Local legislations
- (b) Local regulations
- (c) Rules and standards set by local professional accounting bodies

Every company in Malaysia has to prepare annual reports every year. Section 169 (4) of the Companies Act of 1965 requires every company incorporated under the Act to provide audited financial statements. The annual reports for public listed firms are publicly available in Bursa Malaysia website. Those firms are required to disclose the amount of their audit fees incurred.

In Malaysia, the audit services fees are meant for the statutory audit jobs provided by the external auditors. Public practice accountants are allowed to charge whatever fee that is deemed to be appropriate (Section 240 MIA By-Laws, 2010). Fees charged for assurance services or audit services should be a fair reflection of the value of the work involved and should take into account

- (a) the skills and knowledge required to perform various types of work involved,
- (b) the experience and training level of the person engaged on the work,
- (c) the time usage by each person engaged on the work, and
- (d) the degree of responsibility and urgency that the work entails.

In addition, the by-Laws prohibit the accountants to pay or received payment for certain types of non-assurance engagements such referral fee and commissions.

2.4 Non-audit services

Non-audit services are the services other than the audit services provided either by the auditor and its affiliates or by third party entities. Non-audit services can be categorized as audit-related, tax-related, and miscellaneous. Audit related non-audit services are assurance and related services that are not required by statute or regulation including due diligence services, consulting financial accounting and reporting standards. Tax related services include tax planning, tax compliance and tax advice. They involve a diverse range of services such as preparation of submission of tax returns, refund claims, assistance with tax audits and tax payment-planning service.

The amount of fees paid for non-audit services are not regulated or restricted under any legislation or act. However, the amount incurred should be included or disclosed in the annual reports under item (18) and (19) of Appendix 9C of Bursa Malaysia Listing Requirements for main market and ACE market respectively. Therefore, the public listed companies are required to disclose non-audit fees paid to corporations which are owned by the external auditors or their partners. This disclosure clause was made mandatory by Bursa Malaysia in 2001. The aims are to protect shareholders' interests and to increase corporate transparency. Before 2001, the regulators in Malaysia emphasized only on the disclosure of audit fees in the companies' annual reports, as required by the Companies Act 1965. However, the rules did not clarify whether the clients need to specify the types or nature of non-audit services engagement.

2.5 Auditor independence

Ethics is a global business issue and it is particularly so in a developing nation like Malaysia. The Malaysian Government and businesses continue to struggle with issues of transparency, bribery, and integrity. Despite efforts to improve integrity issues, the Corruption Perception Index (CPI) ranked Malaysia 60 out of 180 countries in 2011 with the score of 4.3 (Transparency International, 2011), demonstrating a deterioration from the previous year when Malaysia was ranked 56 from 178 countries with the score of 4.4 (Transparency International, 2010). A zero score means that the country is perceived as highly corrupt and a 10 means that the country is perceived as very clean. These results revealed that Malaysia's CPI score has averaged below 5.0 for two years in a row, indicating serious corruption issues and practices within the country.

The ethicality of an auditor is measured by the level of independence. An auditor should be independent and be seen to independent. The perceptions of auditor independence became more negative after the collapse of Enron and its audit firm, Arthur Anderson that was declared bankrupt in late 2001. Studies involving auditors found that auditors now perceive that long audit tenure, non-audit services, and other issues that negatively affect the public's perception of independence are more highlighted and attended to than the actual influence of independence. An auditor who is independent has the ability to make independent audit decisions even if there is a perceived lack of independence or if the auditor is placed in a potentially compromising position. Nonetheless, even when the auditor is in fact independent, one or more factors may lead the public to believe that the auditor does not appear independent. This may cause users of financial statements to believe they cannot rely on financial information provided by the auditors (Lindberg and Beck, 2004).

Auditors are by practice are required to maintain independence and ensure integrity of the audit process. They must not at any time resort to corrupt practices. However, many factors such as the tenure of an auditor creep in to erode auditor independence which leads to low audit quality (Wooten, 2003). Low quality audit is reflected in the inability of the auditor to resist client-management pressures in negotiations over financial reporting (Chen *et al.*, 2005). The erosion occurs through friendship or close personal relationships after years of professional dealings. For Malaysia, another shocking news that came to the attention of researchers and regulatory bodies was that accounting irregularities were found in some major companies which are directly linked to the government or have institutional shareholders that are linked to the government. This situation offers another challenge to auditors in Malaysia. Therefore, an auditor should be independent and be seen independent. The International Federation of Accountants (IFAC) (2001) stated that the auditor must be both independent of mind and independent in appearance.

The professional judgment of auditors to provide an opinion must not be affected by the influences that may impair qualities of integrity and objectivity. Independence requires an objective approach and integrity to the audit process. The standards require the auditor to carry out his or her work freely and in an objective manner. An auditor should be honest, sincere, fair, and free of conflicts of interest when performing an audit work and drawing an opinion on the financial statements. The auditor should not allow any prejudice, bias, or influences of others to override his or her objectivity and integrity.

2.6 Knowledge spillover

Knowledge spillover is defined by Carlino (2001) as the exchange of creativity and ideas that promotes innovations. In the auditing context, knowledge spillover is synergy that exists from the joint provision of non-audit services and audit services (Krishnan and Yu, 2011). However, certain non-audit services may be a threat to auditor independence.

2.7 Summary

This chapter highlights the audit market in Malaysia. The market is mostly controlled by the Big Four firms. Every company incorporated in Malaysia is required to comply with the Companies Act of 1965. Under this Act, audit fees incurred must be disclosed in the annual reports. Also, the Bursa Malaysia Listing Requirements also mandate that non-audit fees incurred are to be disclosed. However, this mandatory disclosure did not state the needs of the clients to specify the nature or types of non-audit services.

CHAPTER 3

LITERATURE REVIEW

3.1 Introduction

This chapter presents the literature review undertaken for this research. Section 3.2 gives an overview of the literature on auditor independence and followed by Section 3.3 which discusses the knowledge spillover. Section 3.4 presents literature review of control variables. The summary of this chapter is presented in Section 3.5.

3.2 Auditor independence

Ethics in its broader sense, deals with human conduct in relation to what is morally good or bad, right or wrong. To determine whether a decision is good or bad, the decision maker must then estimate the outcome of the decision. A good question to ask when faced with an ethical dilemma is “Will my actions be fair and just for all parties affected?” The profession provides guidance for auditors faced with ethical dilemmas through professional standards, but the ability of auditors to adhere to prescribe behavior has been questioned (Aw, 2006).

The ethicality of an auditor is measured by the level of independence as an auditor and he or she should be independent and be seen to independent. The definition of independence does not require the auditor to be completely free of all the factors that affect the ability to make unbiased audit decisions, but only free from those that rise to the level of compromising that ability. Auditor independence is an important accounting issue because it bears on the integrity and credibility of the financial reporting. The independence regulations help to ensure quality audits and contribute to the high level of financial reporting.

Auditor independence frees the auditor from external pressures and enables him or her to overcome pressures and other factors that would prevent unbiased audit decisions. The accounting profession under the AICPA Code of Professional Ethics has established categories of ethical standards by which the auditor must continue their independence. These categories include rules of conduct, their interpretations as well as ethical rulings. The independence of an auditor is the foundation for the public's trust in the audit function as it is often referred as an important ethics to the auditors in the auditing profession.

The issue regarding auditor independence has been studied for a long time. It can be seen by various literatures which can be found related to the issue (such as DeFond *et al.*, 2002; Ashbough *et al.*, 2003). Several factors affecting auditor independence have been identified in earlier studies. Among the main factors are audit services fee and non-audit services fee.

3.2.1 Audit services

Audit fee is the remuneration paid for audit services by the client firms. As stated in the 9th Schedule of Companies Act, 1965, companies are required to disclose of the total amount paid or receivable by the auditors as remuneration for their services as auditors inclusive of all fees, percentages, other payments or consideration given by or from the company. The issues related to audit services fees have received much attention as it may affect on the audit quality. It has been argued that the amount of audit services fee paid by the client to the auditor will impair auditor independence (Abu Bakar *et al.*, 2005). It is believed that high audit fee will raise doubt of auditor independence.

The associations between external audit services and the board and audit committee characteristics were examined by Yatim *et al.* (2006) using data from Malaysia. There were positive and significant relationships between audit fees and audit committed expertise, the frequency of audit committee meetings, and board independence. The study also reported a strong negative association between external audit fees and Bumiputera-owned firms. In addition, the internal governance structures of the firms showed that Bumiputera firms employed more favourable corporate governance practices compared to their Non-Bumiputera counterparts.

3.2.2 Non-audit services and audit tenure

Threat arises when an auditor is being influenced by close relationship with an audit client. Long audit tenure appears to be a threat to auditor independence as close relationship and trust developed between the auditor and his or her clients. The impairment of auditor independence will lead to the impairment of audit quality (Chia-Ah *et al.*, 2010). However, Gul *et al.* (2007) suggested that auditor independence may be impaired by non-audit fees when the tenure of the auditor is short, not when the audit tenure is long.

Extended audit tenures have received much criticism from regulators and academicians. That is why the Sarbanes-Oxley Act of 2002 proposes audit partner rotation as one of its principal provisions to enhance auditor independence. Over the years the accounting profession and academics have debated the need for mandatory auditor rotation. If the tenure period was limited, auditors would have greater incentives to resist management pressures (AICPA, 1992, 1-2) and for this reason, the Sarbanes-Oxley Act includes requirements for audit partner rotation. The Act also

required the Government Accountability Office (GAO) to study the issue of mandatory audit firm rotation.

Chen *et al.* (2005) reported a significant positive relation between the interaction of non-audit fees and the auditor tenure variable and the extent of client agreement. However, they did not find a significant relation between auditor tenure and the degree to which the client agreed with the auditor over the financial reporting issues. Moreover non-audit fees do not affect the auditor's ability to resist client management pressure when auditor tenure is longer.

Numerous studies have examined various characteristics of non-audit services and the impact on auditor independence. These studies have either focus on types of non-audit services, recurrence of those services and/or combination of both. Research in this area used sample from the United Kingdom (Ezzamel *et al.*, 2002; Firth, 2002), the United States of America (Huang *et al.*, 2007; Robinson, 2008; Paterson and Valencia, 2011) and New Zealand (Alexander and Hay, 2012).

Firms usually provide to their audit clients a range of services including non-assurance services that are consistent with their skills and expertise. Among the services provided by accounting firms and their affiliates including auditing, accounting and accounting-related-consultancy, taxation, book-keeping, secretarial services and advisory.

There is a negative perception by shareholders, bank loan officers and journalist on auditor independence when there is provision of management advisory services (MAS) (Quick and Warming-Rasmussen, 2005). Thus, independence rules related to MAS should be differentiated. Additionally, the study ascertained that perceived auditor independence does not increase if MAS are provided by a separate department of the audit firm. Also, an internal separation of the consulting and the

auditing function within the same audit firm is not viewed as being beneficial in Denmark (Quick and Warming-Rasmussen, 2005).

Auditor independence has been a continuous concern in the accounting profession and it relates to the issue of rising threat to independence imposed by the provision of non-audit services (NAS) by auditors to audit clients. This is because NAS are performed for the managers and there is inherent incompatibility between audit and non-audit services in terms of functions and reporting relation. In addition, the provision of non-audit services will strengthen the economic bonding between the auditors and the clients and poses a threat to auditor independence (Lai, 2003).

According to Chen *et al.* (2005), auditor industry expertise is central to auditor-client negotiation over financial reporting. It implies that auditor industry specialists will be more likely to resist client management pressures in auditor-client negotiation over financial reporting issues, or that the client will be more receptive to accounting issues raised by a specialist auditor. In dealing with the small medium enterprises the auditor may be able to avoid participating in or offering numerous non-audit services and this will affect auditor-client negotiation, auditor independence, and audit quality. Acquaintance and extended working relationships over long periods of time may also be a factor in contributing to the non-audit services.

In addition, Teoh and Lim (1996) and Abu Bakar *et al.* (2005) also found that audit tenure and non-audit service had a negative relationship with auditor independence. Bartlett (1993) found that bankers and CPAs perceive the independence will be impaired if non-audit service is provided and the auditors will have the highest degree of independence if they provide audit service only. Gul (1989) suggested that non-audit service has positive relationship with auditor

independence while McKinley *et al.* (1985) and Pany and Reckers (1988) found that there was no significant association providing NAS and thus to impair auditor independence (cited in Flaming, 2002).

Lim and Tan (2008) investigated the relation between the provision of non-audit services and the impairment of auditor quality as conditional on auditor specialization. They suggested that the provision of NAS are not necessarily tainted all auditors as audit quality is likely to be impaired with the provision of non-audit services in the case of specialists compared to non-specialist.

There is a very little evidence to support that the provision of NAS impairs auditor independence found by Ashbaugh (2004). Habib and Islam (2007) assumed that the relationship between discretionary accrual and non-audit fee will cause auditor independence impairment. However, they failed to find any relationship between them as they tested the determinants and consequences of non-audit services provision.

Securities and Exchange Commission of the United States has two concerns regarding the provision of NAS. The first concern is that auditors become financially dependent on their clients due to NAS fees, and hence become less willing to stand up to management pressure for fear of losing their business. The other is that the consulting nature of many non-audit services puts auditors in managerial roles, potentially threatening their objectivity about the transactions they audit. The theory and evidence suggests that auditor independence may be impaired when auditors provide non-audit services to their clients (DeFond *et al.*, 2002). However, the evidence on whether non-audit services actually impair independence is inconclusive.

3.2.2.1 Types of non-audit services

The nature of non-audit services has been documented and reported by numerous studies (Ezzamel *et al.*, 2002; Paterson and Valencia, 2011; Alexander and Hay, 2012). Ezzamel *et al.* (2002) analysed non-audit services fees for auditors into five categories, namely, accounting-related, finance advice, tax services, management consultancy, and other non-audit services. Paterson and Valencia (2011), on the other hand, categorised non-audit services into three categories, namely, tax services, audit-related services, and other services. In addition, Alexander and Hay (2012) classified non-audit services into three categories, namely, tax services as recurring non-audit services, consulting services as non-recurring services and other services.

3.2.2.2 Recurring and non-recurring non-audit services

There are not many studies involving the recurring and non-recurring non-audit services. Beck *et al.* (1988) suggested that there would have difference effects on audit fees and on auditor independence if non-audit services are disaggregated into recurring and non-recurring non-audit services (cited in Alexander and Hay, 2012). Alexander and Hay (2012) also investigated the effect of non-recurring and recurring non-audit services on audit fee. There was no significant relationship showed between non-recurring non-audit services and audit fees. Also, the relationship between recurring non-audit services and audit fees were either not significant or positive association when both recurring and non-recurring services provided.

On the other hand, Paterson and Valencia (2011) examined the association between recurring and non-recurring non-audit services with restatements. They found a negative relationship between recurring tax services with restatements, suggesting that knowledge spillovers occurred due to additional acquired knowledge